

## **EXHIBIT B**

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*"One drawback is that previous attempts at installing kiosks in music stores have recently failed to engage consumers. At the turn of the decade, IBM teamed up with Blockbuster to unveil NewLeaf Entertainment, which downloaded music onsite, but the project failed to ignite much interest. Another format was attempted by Personics, which allowed consumers to create their own mix tapes at stores. But with the record companies refusing to license their biggest hits for fear they'd hurt album sales, Personics also quickly faltered."*

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pageid=rs.newsarchive&pageregion=mainregion&rnd=1132266623859&has-player=true](http://www.rollingstone.com/news/story/_/id/5925643/thebeatles?pageid=rs.newsarchive&pageregion=mainregion&rnd=1132266623859&has-player=true)

[http://www.minidisc.org/sony\\_kiosk.html](http://www.minidisc.org/sony_kiosk.html)

<http://www.ee.surrey.ac.uk/Contrib/Edupage/1995/08/31-08-1995.html#6>

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# THE WALL STREET JOURNAL. ONLINE

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## SPECIAL REPORT: E-COMMERCE

### Looking for Harmony

*New technology could bring record stores into the digital age. Why hasn't it?*

By JASON FRY

Imagine this: You walk into a record store looking for a CD -- say, Bruce Springsteen's 1973 "The Wild, the Innocent & the E Street Shuffle." The record store doesn't have it, but there's no reason to leave empty-handed.

Kiosks in the store offer information, including song previews, album art and reviews, about thousands of U.S. releases -- many more than are in stock. You find the Springsteen album and discover you can have a copy made for you while you continue shopping. Within minutes, the songs have been downloaded over a secure computer network and burned onto a recordable CD, along with color printouts of the album art and liner notes. Everybody's happy -- you've got your CD, and the retailer, the record label and Bruce Springsteen have all made a sale.

Sounds simple. But it isn't.

That's the lesson learned by RedDotNet, a unit of Alliance Entertainment Corp., a Coral Gables, Fla., music distributor and supplier of back-end services, in more than two years of working with the recording industry in trying to make such a system a success. The technological underpinnings of the system work. In-store tests suggest customers like it. Yet the system remains stillborn.

Why? In part it's because RedDotNet (<http://www.reddotnet.com/><sup>1</sup>) got caught by a sea change in retailers' attitudes that's left them focused on moving as much of their current inventory as they can, rather than looking for new sales opportunities. But recording-industry critics say that a deeper problem has been the industry's refusal, at least so far, to license enough content to make the system viable.

Meantime, RedDotNet and its rivals have retrenched, rolling out systems that offer lots of information about CDs but not the ability to create them on demand. Such a step will have to wait until the recording industry is ready to accept it. And those who have come before warn that change could be a long time coming.

"The recording industry has traditionally been hostile to every new technology as it emerges,"

### E-COMMERCE

• Special Report Main Page

• Clicks in Bricks

• Beyond Bookings

• Web Watch

• Technical Adviser

• Public Disservice

• Renew It or Lose It

• Rules & Regs

• Click and ... Drive?

• The Empire Builder

• Behind the Curtain

• Deja Vu

says Tom Sharples, president and chief technologist of Qorvus Systems Inc. (<http://www.qorvus.com/><sup>3</sup>), a Vancouver, Wash., research-and-development firm focusing on wireless networking and the design and development of kiosks. "That's because they're extremely myopic about what the possible implications of each new technology -- even for their own interests -- might be."

Recording-industry officials decline to discuss digital distribution, as do most labels involved with RedDotNet.

### Limited Library

Mr. Sharples formed his impression during his time as senior vice president for engineering at Personics, the granddaddy of attempts to provide an alternative to the record industry's traditional distribution business. Between 1988 and 1990, Personics kiosks were available in some 250 stores. Customers could hear samples of the 6,000 songs available on the system, pick the ones they liked, and after less than 10 minutes walk out with a compilation cassette, complete with a personalized cover, for around \$12.

Mr. Sharples estimates the major labels made less than 3% of then-current hits available, leaving Personics to make do mostly with oldies and also-ran material from current artists. But that didn't matter at first, he says: "Even with such a puny library, we were able to do very, very well with the system."

Mr. Sharples says some Personics units in New York City locations were raking in \$800 a day -- not bad, considering each kiosk cost about \$125 a day to run.

But while he says some in the recording industry supported Personics, others felt differently. Legally, the labels could withdraw songs from the system with essentially 24 hours' notice, something Mr. Sharples says they started to do about six to nine months after Personics reported its success in New York.

By late 1990, most of the 500 or so songs that contributed to 80% of Personics's business had been pulled back, leaving the kiosks barely pulling in \$100 a day. In December 1990, a command sent out via modem from Personics headquarters in Redwood Shores, Calif., shut the kiosks down; the next year, Personics filed for bankruptcy protection and was acquired by New York-based Time Warner Inc. Today, a kiosk in Mr. Sharples's garage is one of the few remnants of the project.

"The thing that's so particularly cruel at this point is that the industry is taking a sort of holier-than-thou approach to companies like Napster" by assailing them for not having licensed the material changing hands on their networks, Mr. Sharples says. Personics was no Napster, he says, noting that the company did its best to comply with what he calls incredibly arcane and convoluted requirements. "Despite that," he adds, "we were forced out of business by the very content holders we were trying to please."

### Auspicious Beginning

RedDotNet's story reads somewhat the same way.

The company was itself built on the rubble of another digital-distribution experiment: New Leaf

Entertainment Inc., a joint venture between **International Business Machines Corp.** and **Blockbuster Entertainment Corp.** New Leaf was opposed by the leading record labels and dismantled in early 1995, with most of its intellectual property and assets becoming the property of **Digital On-Demand**, a Carlsbad, Calif., company founded by engineer Tom Szabo in December 1997. The company was known formally as **Digital On-Demand**, and in practice as **RedDotNet**.

Working from offices above a grocery store, Mr. Szabo and his team picked up where New Leaf had left off, and soon found an interested customer in **Walt Disney Co.** In April 1998, the company struck a deal with Disney to put kiosks in Disney stores. There, visitors could preview songs from Disney's catalog and create compilation CDs, complete with printed covers and labels.

The first such CD was created on May 22, 1998 at Disneyland in Anaheim, Calif. The **RedDotNet** kiosks proved popular; that first machine is still in operation today. The deal with Disney, of Burbank, Calif., was an important test that **Digital On-Demand** passed, but in time it would seem the exception that proved the rule. What worked with one single company selling its own content in its own stores wouldn't fare as well with multiple companies' content being sold by a number of different retailers.

In June 1999, **Digital On-Demand** struck a deal with **Sony Music Entertainment**, a unit of Japan's **Sony Corp.**, to digitally distribute its recordings. Two days later, retailers **Virgin Entertainment Group** and **Trans World Entertainment Corp.** agreed to install the **RedDotNet** kiosks in select music stores. Later that summer, deals followed with **EMI Group PLC's EMI Recorded Music** and retailer **Wherehouse Entertainment Inc.** **Universal Music Group**, now a part of **Vivendi Universal SA**, came on board in June 2000, and **Bertelsmann AG** unit **BMG Entertainment** followed suit in January 2001.

**RedDotNet** seemed poised to succeed. But it didn't play out that way. Anthony Deen was vice president of retail design and brand development for **Virgin Entertainment Group's Virgin Megastores North America** when **RedDotNet's** kiosk was tested at a new store in the Easton Mall in Columbus, Ohio, in July 1999. Mr. Deen, now vice president of design for New York-based design firm **CDI Group**, says that while the lines to use the **RedDotNet** kiosk in the Columbus store showed **Virgin** the concept was sound, the retailer wasn't impressed enough to roll out the machines elsewhere. He does note that many customers were not requesting out-of-stock albums but making compilations -- a sore point for some labels that fear they cut into sales of full-length CDs.

"We were ready to do Times Square and San Francisco as well," he says, "but Columbus never produced the kind of numbers that would make a retailer feel warm and fuzzy."

Changes were afoot at **Digital On-Demand**, too. In late 1999, the company was acquired by **Alliance Entertainment** in a stock-and-cash transaction valued at between \$75 million and \$125 million. (Mr. Szabo remained CEO for the transition and is now chairman and CEO of **Telanetix**, a Carlsbad, Calif., company specializing in real-time communications for educational institutions and corporations. He remains on **Alliance's** board.) In late 1999, the company said plans for a larger rollout would be deferred.

What went wrong? For one thing, the combination of **Digital On-Demand's** fees and the fees charged by the labels made the CDs expensive -- between \$21 and \$32 for a reproduction of an

album, according to Mr. Deen. Mr. Szabo says the Virgin kiosk was a technological proof of concept and not a test of economics, adding that the early test systems cost more because there weren't enough machines on the network to bring overall prices down.

Eric Weisman, Alliance's president and chief executive officer, points to another problem: changing goals for retailers. With consolidation afoot and retailers struggling, the top priority became to sell as much of the inventory they had on hand as possible. Making additional revenue by supplying out-of-stock items became a decidedly secondary goal, and that undercut any hopeful signs from RedDotNet's trials.

"We had the right technology, and we had the right technology that could be applied right then and there," Mr. Weisman says. He adds that RedDotNet needed to "time it better for when the marketplace realigned itself."

Another problem was the same one that plagued Personics: lack of content.

Mr. Weisman says he's not contractually permitted to say what percentage of a label's catalog was made available. But he does say that "quite honestly, you'd have to say [the record labels] were conservative with the granting of rights," adding that "we would have loved to have more catalog available at the time and expect to have more available in the future."

Pete Jones, president and CEO of BMG Distribution and BMG Associated Labels, says BMG has made thousands of titles available to RedDotNet, representing as much as 40% of BMG's catalog. "I think everybody would agree that it's a good idea," he says of RedDotNet's digital-distribution system, adding that BMG certainly hasn't given up on it.

Officials at the other labels that struck deals with RedDotNet declined to comment on digital distribution in general and RedDotNet in particular.

Meantime, RedDotNet hasn't been idle. It has shrunk its kiosks and aimed them at helping customers decide on purchases, a strategy intended to help retailers move as much in-stock inventory as possible.

The RedDots, which are kiosks about the size of a Frisbee, come in a variety of forms. One has a bar-code scanner, two dials and a pair of headphones. Hold up a shrink-wrapped CD to the scanner and you can preview all the songs on it. Another variety works the same way, but also offers a touch screen letting you search a database of about 200,000 CDs available in the U.S., getting sound clips, album art and reviews. Different RedDot models are updated in different ways, from DVD updates to DSL connections and satellite links, as often as weekly, to get new data supplied by Alliance's All Music Guide unit.

### **The Burning Question**

One thing the system lacks is the very thing touted in the beginning: the ability to download and burn a copy of an out-of-stock CD. Mr. Weisman says the existing system can be retrofitted with that capability -- a point BMG's Mr. Jones makes as well. But when will the time be right for that? Mr. Weisman says he "would imagine sometime in 2003" Alliance will begin to look at such a combination. (In June, Alliance agreed to merge with Liquid Audio Inc., a Redwood City, Calif., maker of software and services for delivering music downloads online, in a complicated reverse merger that also sets the stage for Alliance to become a publicly traded

company.) But any plan for 2003 will require a solution to the persistent problem of getting the record labels to license enough songs to make digital distribution of music feasible.

Mr. Sharples isn't holding his breath. "Everybody that's come along since then has tried to make the same arguments" Personics made, he says. "The content owners are as myopic today as they were back then. And, frankly, I don't see that changing."

--Mr. Fry is an editor for *The Wall Street Journal Online* in New York.

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